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IN THE
Supreme Court of the United States
OCTOBER TERM, 1982

RAYMOND L. DIRKS,
Petitioner,

v.

SECURITIES AND EXCHANGE COMMISSION,
Respondent.

Petition For Writ Of Certiorari To The United States Court Of Appeals For The District Of Columbia Circuit

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QUESTIONS PRESENTED

Did the Court of Appeals err in holding liable under the antifraud provisions of the securities laws an analyst—who repeated allegations of corporate fraud made by several former and present company employees, but denied by management, to many persons, some of whom later sold stock on the open market without disclosing the allegations—on the theory that:

(1) Employees of a registered broker-dealer are "required to meet a high standard of ethical behavior" and therefore automatically have "a duty to the [Securities and Exchange] Commission and the [general] public" that satisfies the fiduciary duty requirement of *Chiarella* v. *United States*, 445 U.S. 222 (1980)?

(2) Under *Chiarella* v. *United States*, *supra*, unverified allegations of fraud made by insiders necessarily carry with them a duty not to repeat the allegations to persons who may sell on the open market even if the analyst himself neither has any preexisting fiduciary duty nor obtains the allegations through any breach of an insider's fiduciary duty?

(3) Unverified allegations of fraud vigorously denied by management are nonetheless "material facts" under the securities laws and *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438 (1976)?

TABLE OF CONTENTS

	Page
QUESTIONS PRESENTED	i
TABLE OF AUTHORITIES	iv
OPINIONS BELOW	1
JURISDICTION	2
STATUTORY AND REGULATORY PROVISIONS	2
STATEMENT OF THE CASE	2
I. Proceedings Below	2
II. Relevant Facts	5
REASONS FOR GRANTING THE WRIT	11
I. The Decision Of The Court Below Raises Issues Of Great Importance To The Proper Functioning Of The Securities Industry	11
II. The Decision Of The Court Below Is Inconsistent With This Court's Decision In *Chiarella*, Creates A Conflict In The Circuits, And Violates The Plain Meaning Of The Statute	14
A. The Decision of the Court Below that Anyone Associated with a Broker-Dealer Automatically Owes a Fiduciary Duty to the Public and the SEC Is an Unprecedented and Unsupported Effort to Circumvent *Chiarella*	14
B. The Decision of the Court Below that the Recipient of Information from Corporate Insiders May Inherit the Insiders' Fiduciary Duties to Shareholders or Purchasers, Even If the Insiders Breached No Duties in Disclosing Such Information, Is Contrary to *Chiarella* and Creates a Conflict Within the Circuits	18
C. The Finding of the Court Below that Unverified Rumors Are "Material Facts" Is Incorrect and Will Interfere with the Work of Analysts	21
CONCLUSION	25
APPENDIX	
Opinion of the United States Court of Appeals for the District of Columbia Circuit, dated May 18, 1982	A-1

Table of Contents Continued

Page

Opinion of the Securities and Exchange Commission, dated January 22, 1981 ..... B-1

Judgment of the United States Court of Appeals for the District of Columbia Circuit, dated March 29, 1982 C-1

Order, dated May 19, 1982, denying petition for rehearing C-3

Order, dated May 19, 1982, denying rehearing *en banc* C-4

Statutory and Regulatory Appendix D-1

TABLE OF AUTHORITIES

CASES: Page

Alaska Interstate Co. v. *McMillan*, 402 F. Supp. 532 (D. Del. 1975) 22

In re Cady, Roberts & Co., 40 S.E.C. 907 (1961) 22

Chiarella v. *United States*, 445 U.S. 22 (1980) ..... *passim*

Financial Industrial Funds, Inc. v. *McDonnell Douglas Corp.*, 474 F.2d 514 (9th Cir.), *cert. denied*, 414 U.S. 874 (1973) 21

Hassig v. *Pearson*, 565 F.2d 644 (10th Cir. 1977) 21

Marx & Co. v. *The Diner's Club, Inc.*, 550 F.2d 505 (2d Cir.), *cert. denied*, 434 U.S. 861 (1977) 21

Mitchell v. *Texas Gulf Sulphur Co.*, 446 F.2d 90 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971) 22

Pachter v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.* 444 F. Supp. 417 (E.D.N.Y.), *aff'd mem.*, 594 F.2d 852 (2d Cir. 1978) 23

SEC v. *Lund*, [1981-82] Fed. Sec. L. Rep. (CCH) ¶ 98,428 (C.D. Cal. 1982) 11

SEC v. *Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969) . 22

TSC Industries, Inc. v. *Northway, Inc.*, 426 U.S. 438 (1976) 21

Walton v. *Morgan Stanley & Co., Inc.* 623 F.2d 796 (2d Cir. 1980) 20, 21

Wiener v. *Oppenheimer & Co.*, [1979] Fed. Sec. L. Rep. (CCH) ¶ 96,764 (S.D.N.Y. 1979) 23

United States v. *Naftalin*, 441 U.S. 768 (1979) 16

STATUTES AND RULES:

California Corporation Code § 3019 (1955), renumbered with technical emendations, as California Corporation Code § 2254 (1977) 19

Securities Exchange Act of 1933

Section 17(a), 15 U.S.C. § 77q(a) ..... *passim*

Securities Exchange Act of 1934

Section 10(b), 15 U.S.C. § 78j(b) ..... *passim*

Table of Authorities Continued

Page

Rule 10b-5 of the Securities and Exchange Commission, 17 C.F.R. § 240.10b-5 ..... *passim*

LEGISLATIVE MATERIALS:

Hearings Before Subcomms. of the Senate Comm. on Appropriations, 93d Cong., 1st Sess. 90 (1973) . 10, 23

OTHER AUTHORITIES:

Heller, *Chiarella, SEC Rule 14e-3 and Dirks: "Fairness" versus Economic Theory*, 37 Bus. Law. 517 (1982) 11

Herman, *Equity Funding, Inside Information, and the Regulators*, 21 U.C.L.A. L. Rev. 1 (1973) 12

Langevoort, *Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement*, 70 Calif. L. Rev. 1 (1982) 12, 20

Lorie, *Insider Trading: Rule 10b-5, Disclosure, and Corporate Privacy: A Comment*, 9 J. Legal Stud. 819 (1980) 12, 25

Scott, *Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy*, 9 J. Legal Stud. 801 (1980) ... 12

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Petitioner Raymond L. Dirks respectfully prays that a Writ of Certiorari issue to review the judgment of the United States Court of Appeals for the District of Columbia Circuit in the above-entitled case.

OPINIONS BELOW

The March 29, 1982 judgment of the Court of Appeals is not reported; it is reprinted in the Appendix at page C-1. The May 18, 1982 opinion of the Court of Appeals is reported unofficially at [Current] Fed. Sec. L. Rep. (CCH) ¶ 98,669 and is reprinted in the Appendix beginning at page A-1. The opinion of the Securities and Exchange Commission is reported unofficially at [1981] Fed. Sec. L. Rep. (CCH) ¶ 82,812, and is reprinted in the Appendix beginning at page B-1. The Initial Decision of Administrative Law Judge David Markun is published in *In re Boston Company Institutional Investors, Inc., et al.*, [1978] Fed. Sec. L. Rep. (CCH) ¶ 81,705 (1978).

JURISDICTION

The judgment of a divided panel of the Court of Appeals (Judge Tamm dissenting) was entered on March 29, 1982. A timely Petition for Rehearing and Suggestion for Rehearing *En Banc* was filed on April 27, 1982. On May 18, 1982 Judge Wright filed an opinion in support of the judgment. Judge Robb concurred in the result only. Judge Tamm dissented. The Petition for Rehearing and Suggestion for Rehearing *En Banc* was denied on May 19, 1982. (App. C-2 and C-3) This petition is filed within 90 days of that denial. This Court has jurisdiction pursuant to 28 U.S.C. § 1254(1).

STATUTORY AND REGULATORY PROVISIONS

This case involves Section 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a); Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b); and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5. The provisions of these statutes and regulation are set forth in the Appendix beginning at page D-1.

STATEMENT OF THE CASE

I. Proceedings Below

Petitioner Raymond L. Dirks is a professional investment analyst. In early March 1973 Dirks was contacted by a former employee of Equity Funding Corporation of America ("Equity Funding" or "EFCA"), which was a major insurance holding company listed on the New York Stock Exchange. This former employee told Dirks that he believed that Equity Funding was engaged in a massive fraud involving, among other things, the creation of fictitious insurance policies. Similar allegations had been investigated previously by the SEC, which had failed to substantiate them, and were at the same time again made to the SEC, which failed to act.

Dirks, however, investigated these allegations himself and also attempted to have them investigated and publicized by *The Wall Street Journal*. Some of the allegations turned out to be true; others proved to be false. Largely as a result of Dirks' efforts, one of the largest business frauds in history was uncovered.

In the course of his investigation, Dirks told many members of the investment community about the allegations of fraud. While most of these people discounted the unconfirmed allegations and some even bought Equity Funding stock after hearing them, others sold stock on the open market without disclosing the allegations. Neither Dirks nor his firm owned or traded any Equity Funding stock.

After the Equity Funding fraud was exposed, the SEC shocked the investment community by charging and then finding that Dirks had violated and aided and abetted violations of Section 10(b), Rule 10b-5, and Section 17(a) of the securities laws when he repeated the allegations of fraud to members of the investment community who later sold their Equity Funding stock.[1] Recognizing that Dirks played "an important role in bringing EFCA's massive fraud to light," that Dirks "reported the fraud allegations to EFCA's auditors and sought to have the information published in *The Wall Street Journal*," and that in twenty years as an analyst Dirks had an "unblemished" record, the Commission reduced the sanction imposed by an Ad-

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[1] Five sellers of Equity Funding securities were also named as respondents in the SEC administrative proceedings: The Boston Institutional Investors, Inc., The Dreyfus Corporation, John W. Bristol & Co., Tomlin, Zimmerman and Parmalee, Inc., and Manning and Napier, Inc. Four of the trading respondents were censured; no sanction was imposed on the fifth. None of them sought review of the Commission's decision.

ministrative Law Judge from a sixty-day suspension to a censure. (App. B-26)

In a three-paragraph judgment, a divided panel of the United States Court of Appeals for the District of Columbia Circuit denied Dirks' Petition for Review of the SEC decision on the ground—not mentioned at any point by the SEC—that Dirks "breached his duty to the Commission and to the public not to misuse insider information and that he was compensated for so doing." (App. C-1) After petitioner sought rehearing, Judge Wright issued a 41-page opinion in support of the judgment. Judge Robb concurred in the result only and Judge Tamm dissented.

Judge Wright noted in his opinion that this case involves "both sensational facts and difficult issues of law and policy." (App. A-2) Judge Wright observed that investment analysts can play an important independent role in ferreting out corporate fraud and conceded that "[l]argely thanks to Dirks one of the most infamous frauds in recent memory was uncovered and exposed, while the record shows that the SEC repeatedly missed opportunities to investigate Equity Funding." (App. A-3) Judge Wright also observed that the threat of liability under the antifraud provisions of the securities laws may impede such investigations in the future. (App. A-3)

Nevertheless, Judge Wright found that Dirks had breached a legal duty of disclosure that he owed "to the SEC and to the public" solely because he was an investment analyst employed by a broker-dealer, and as a member of the securities industry, was therefore "required to meet a high standard of ethical behavior." (App. A-27 to A-31) Judge Wright found that this duty to disclose was "created by the ethical standard that applies to broker-dealers" and that Dirks, in "failing to report promptly

what he knew" to the SEC and the public, breached this duty. (App. A-29, A-31)

Judge Wright also found that since Dirks had heard the allegations about fraud at Equity Funding from former employees and one present employee of Equity Funding, he was a "tippee" of corporate insiders. Because both federal and relevant state law require the disclosure of fraudulent management activities, both the SEC and Judge Wright conceded that these "insiders," in disclosing the alleged fraud to Dirks, had not breached any fiduciary duty. (App. A-23 to A-25) Moreover, it was undisputed that Dirks himself was a stranger with no preexisting fiduciary duty to seller or buyer. Nevertheless, Judge Wright found that Dirks had automatically acquired a fiduciary duty to "disclose or refrain" from trading on information acquired from the corporate insiders and that he breached that duty when he repeated the allegations to others, some of whom later sold Equity Funding stock.

Finally, Judge Wright found that the information in Dirks' possession constituted "material facts" for purposes of the securities laws, even though that information consisted of unverified allegations that did not come "from a source whose word would not be doubted." (App. A-34 to A-35)

II. Relevant Facts

The underlying facts, while "sensational," are largely not disputed. From the middle 1960s through the early 1970s, Equity Funding was regarded by the Wall Street investment community as a highly attractive "growth" company. In November 1971, the Los Angeles regional office of the Securities and Exchange Commission was told that Equity Funding's controller was making allega-

tions of fraud at the company, specifically that Equity Funding was overstating the amount of insurance in force by placing phony policies on its books. The SEC conducted an investigation, rejected an offer by the then former controller to provide information about substantial fraud at Equity Funding in exchange for immunity, found no incriminating evidence and closed its investigation. (J.A. 910-13)

On the morning of March 7, 1973, Ronald Secrist, a former employee of two of Equity Funding's life insurance subsidiaries, met with the New York Insurance Department and made allegations of fraud at Equity Funding in some detail, primarily to the effect that Equity Funding had phony policies on its books and that these policies were being sold to reinsurers as though they were real. These allegations were relayed to the California Department of Insurance, which in turn passed them on to the SEC on March 9, 1973. The SEC Los Angeles regional staff reported that they had previously heard similar allegations by disgruntled employees which did not prove out and recommended that any inspection of Equity Funding operations be delayed until the next year when more personnel would be available. The SEC took no action on the allegations. (J.A. 888-97, 898)[2] A number of state insurance departments did subsequently commence an intensive audit, but during the relevant time period found no evidence of wrongdoing. (J.A. 879-80)

However, also on March 7, 1973, Secrist conveyed the same allegations to Petitioner Dirks, who was then a highly respected securities analyst employed by Delafield Childs, a small Wall Street firm. Dirks was a specialist in

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[2] References are to the Joint Appendix filed with the Court of Appeals.

the insurance industry and had a reputation for conducting aggressive and independent investigations of the companies he reported on. (App. B-3)

Secrist told Dirks that he had recently left an Equity Funding subsidiary, Bankers National Life Insurance Co., in protest over the way it was operated, and that there was substantial financial manipulation occurring at Bankers Life. (In fact, it subsequently turned out that there was no substantial wrongdoing at Bankers Life and that Secrist had not resigned in protest but had been fired.) (J.A. 123-25, 151-52, 174-75, 231-32, 542-43, 1016, 1036)

With respect to another Equity Funding subsidiary, Equity Funding Life Insurance Company of America ("EFLIC"), Secrist made essentially the following allegations: in 1970, EFLIC had embarked on a program of selling totally fictitious life insurance policies to reinsurance companies and one-third of EFLIC's insurance in force was fake; fictitious death certificates were created in order to collect proceeds of these policies from reinsurers; in order to reflect the receipt of premiums, EFLIC had printed its own bank statements, showing false deposits, and counterfeited certificates of deposit; Equity Funding's real assets amounted to $10,000,000 rather than the reported $250,000,000 to $500,000,000; Equity Funding was selling limited partnerships in phony apartment houses; leading Equity officials had sold much of their Equity Funding stock in the previous six months and each had cash and a passport, ready to flee the country at a moment's notice; Equity Funding had connections with the Mafia and would obtain contracts on people's lives if they caused trouble; Haskins & Sells, EFLIC's former auditors, had become suspicious of EFLIC and had dropped the account. (It ultimately turned out,

although Dirks did not know it at the time, that the first three allegations were essentially correct and the remainder false.) (J.A. 53-58, 64, 66-67, 79-80, 152-53, 165, 175-79, 182-83, 205-06, 210, 214, 227, 1212-13, 1240-41)

These allegations were, on their face, improbable because the scheme alleged by Secrist would have required Equity Funding to carry out a massive fraud under the noses of three major accounting firms it had used as auditors, the SEC, the New York Stock Exchange, three or four state insurance commissions that regulated Equity Funding's operations, and various prestigious brokerage firms and banks. (J.A. 283-84)

Dirks nonetheless investigated and discovered that several former and one present Equity Funding employees were inclined to believe some of the allegations made by Secrist, although they had only a little firsthand knowledge and disagreed with some of the allegations. (J.A. 312-14, 365, 411-13, 416-19, 420-22, 424, 427-29, 444, 446-47, 455, 1229, 1230-31, 1319) Dirks confronted Equity Funding's top management with the allegations. The President of Equity Funding emphatically denied the allegations in detail. (J.A. 1225-26) Despite management's denials, Dirks continued his investigation since some people with whom he talked tended to believe some of the allegations.

Dirks also attempted to have the allegations get the same type of publicity that customarily is accorded such rumors within the investment community. Within a few days of his meeting with Secrist, Dirks telephoned *The Wall Street Journal* and was eventually put in touch with William Blundell, a skilled investigative reporter in the *Journal*'s Los Angeles office. Dirks reported to Blundell the allegations about Equity Funding. (J.A. 552-58, 933-35, 1226-27, 1319) Blundell told Dirks that Blundell could

not write a story based on the Secrist allegations because they were "flat out rumors" supported only by hearsay from former employees. (J.A. 941-43) Dirks, however, kept Blundell informed of his investigation on a daily basis and Blundell proceeded to conduct his own investigation, which included talking to Dirks' sources. (J.A. 941-43) Dirks badgered Blundell to write a story, but Blundell refused to do so until after the events involved in this proceeding.

In the meantime, Dirks met with and reported the allegations to Equity Funding's present (Seidman & Seidman) and former auditors (Haskins & Sells), who did nothing. (J.A. 506, 509, 511-13, 562-63, 1233-34) He also spoke with members of the investment community. Dirks initiated some of these conversations in an attempt to determine if the Secrist allegations could have any substance. (J.A. 497-98, 745, 768-71, 1156, 1191) As Dirks' investigation proceeded and rumors circulated throughout the investment community about the allegations of fraud and wrongdoing at Equity Funding, he also took calls from various persons who were seeking to find out what he had heard about Equity Funding. (J.A. 517-20, 578-79, 633, 639, 732-33, 785-95, 1205, 1320) Dirks spoke with anyone who sought to contact him and conveyed the substance of what he had heard, including any information which tended to undercut the allegations. Some of those with whom Dirks spoke sold on the open market, some of them bought, and some of them did not change their positions in Equity Funding stock. (J.A. 573-75, 577-80, 1000-01, 1004, 1012, 1185, 1208, 1237-38, 1320)

Dirks himself did not own or trade any Equity Funding stock. (J.A. 1209)

The President of Equity Funding met on March 23 with two staffers of the New York Stock Exchange, at their

request, to discuss the rumors. After hearing his explanation, the NYSE took no further action. (J.A. 966-67, 1267) As noted, the SEC had been advised of allegations of fraud at Equity Funding as early as 1971, had investigated and had found no basis for proceeding against the company. The SEC was subsequently advised of the allegations at least twice in March 1973—on March 9 by the California Insurance Department and on March 23 in a conversation between Blundell of *The Wall Street Journal* and representatives of the SEC's Division of Enforcement. In each instance the SEC did not act upon the allegations. (J.A. 888-98, 948-50, 1268)

Stanley Sporkin, who was then Deputy Director of the SEC Division of Enforcement and participated in the March 23 conversation, later explained to Congress why he waited nearly a week after Blundell's detailed account to press for the suspension of trading in Equity Funding securities:

> "I just wanted to emphasize what I think the Chairman had mentioned, that we cannot suspend trading merely on the basis of some rumor. We must have more information than that. In this case, in fact, a lot more had been done at that time. The [NYSE] had called Equity Funding in and Mr. Goldblum of the company had denied these rumors. We were really in a quandry on the week of March 26 about what we should do. We had no real verification of the facts." Hearings Before Subcomms. of the Senate Comm. on Appropriations, 93d Cong., 1st Sess. 90 (1973).

At Blundell's suggestion Dirks, along with two former Equity Funding employees, met with the Regional Administrator of the SEC's Los Angeles office on March 27. Dirks spent four days telling the SEC everything he had heard about the allegations of fraud at Equity Funding. (J.A. 566)

Finally, on March 27, in response to the circulating rumors of fraud at Equity Funding, the New York Stock Exchange suspended trading in the company's stock. The SEC suspended trading in Equity Funding stock on March 28, even though the SEC official, after talking with Dirks for two days, was not convinced that the rumors were true. (J.A. 923, 926, 1269-70)

When trading was suspended in Equity Funding stock, the *Journal* still had insufficient evidence on which to write a story and there was no hard evidence that any of the allegations were true. Finally, on March 30, the Illinois Insurance Department discovered that substantial cash assets of Equity Funding, which were supposed to be in a Chicago bank, were missing and officers of Equity Funding refused to sign affidavits swearing that there was no fraud. At this point the California Insurance Department stepped in, using its emergency powers to seize EFLIC, and Blundell then wrote a story in the *Journal* detailing the allegations. (J.A. 565-66, 955-56, 1235-36) On April 5, 1973 Equity Funding filed a bankruptcy petition.

REASONS FOR GRANTING THE WRIT

I. The Decision Of The Court Below Raises Issues Of Great Importance To The Proper Functioning Of The Securities Industry

This cases raises major questions regarding the appropriate role of securities analysts. These are issues of tremendous importance to the investment community, and this case has, accordingly, been the subject of considerable court comment and scholarly debate. *See, e.g.*, *SEC* v. *Lund*, [1981-82] Fed. Sec. L. Rep. (CCH) ¶ 98,428 (C.D. Cal. 1982); Heller, *Chiarella, SEC Rule 14e-3 and Dirks: "Fairness" versus Economic Theory*, 37 Bus. Law. 517 (1982); Langevoort, *Insider Trading and*

the Fiduciary Principle: A Post-Chiarella Restatement, 70 Calif. L. Rev. 1, 30-31 (1982); Scott, *Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy*, 9 J. Legal Stud. 801, 813 (1980); Lorie, *Insider Trading: Rule 10b-5, Disclosure, and Corporate Privacy: A Comment*, 9 J. Legal Stud. 819 (1980); Herman, *Equity Funding, Inside Information, and the Regulators*, 21 U.C.L.A. L. Rev. 1 (1973). Moreover, the decision of the Court of Appeals places severe limits upon what an independent securities analyst may do in the course of investigating and seeking to confirm rumors about past activities, including fraud, at a public corporation without running afoul of the anti-fraud provisions of the federal securities laws. The decision below casts great uncertainty into the work of these professionals and will gravely impair their ability and willingness to investigate allegations of corporate fraud.

The prime function of securities analysts and a major portion of the business of the securities industry involve research, often in-depth research, on companies whose stock is traded in the securities markets. Making that research available to clients or potential clients, either by selling the research or recovering the costs through commissions on stock transactions, is a normal activity of securities firms that is an integral element in the proper functioning of the securities markets.

In conducting his investigation, Dirks was engaging in the normal activities of securities analysts. As even the court below recognized, the important public benefits of these activities cannot be denied. While various regulatory agencies heard the allegations of fraud at Equity Funding over a period of several years, they took no effective action. But within three weeks of Dirks' beginning his investigation, during which time the allegations spread throughout the marketplace, trading in Equity Funding

stock had been suspended and investigations had begun that would confirm the allegations.

The Court of Appeals decision will substantially inhibit these desirable activities of securities analysts. Under the decision, an analyst like Dirks who hears of allegations of fraud has two choices. He can make the allegations public, which as the present case demonstrates, is practically impossible for an analyst who has no control over the regulatory process or the media. In fact, the allegations had been reported to the regulatory agencies, with no results, and the *Journal* refused to print any story on the allegations.

Alternatively, he can remain silent. Indeed, in its oral argument to the Commission the SEC staff explicitly argued that what Dirks should have done with the allegations was "nothing."

Either way, the public is deprived of the benefits of independent investigations because the analyst has no incentive to investigate. Worse yet, any analyst who is foolhardy enough to uncover allegations of fraud will be subject to Section 10b-5 liability if those to whom he repeats the allegations trade with those who do not hear of them.

Such a result is entirely contrary to public policy since it inhibits the reasonable workings of the securities markets and, as in the present case, would discourage the investigation of wrongdoing. Indeed, Judge Wright himself noted:

> "Both the state and the public at large have an interest in exposing corporate misconduct. Ordinarily, we would expect that official law enforcement agencies would be sufficient for that task, but this case shows that the organs of government are not always able to accomplish swift investigation of possible

> crimes. The press also has an historic role in discovering and exposing wrongdoing, but here, too, the press failed to move as quickly as Dirks, who had more immediate financial and reputational incentives to discover the truth about Equity Funding." (App. A-25 to A-26)

The decision below removes those "financial and reputational incentives" by imposing on analysts an obligation, if their research uncovers any evidence of fraud or misconduct, to disclose it publicly (which, as noted, is probably impossible) or face the prospect of a securities fraud charge themselves. This virtually guarantees that neither Dirks nor any other securities professional will invest his time and energy in investigating allegations of corporate fraud. This result is contrary to the common understanding of the role of the securities analyst and contrary to common sense. It is based on the explicit assumption that it is illegal to hope for financial reward for diligent service to the community, an assumption without support in the securities laws. And it raises an issue of significant importance to the securities industry that deserves this Court's attention.

It also conflicts with the decision of this Court in *Chiarella* v. *United States*, 445 U.S. 222 (1980), and creates a conflict with the Second Circuit Court of Appeals, as set forth below.

II. The Decision Of The Court Below Is Inconsistent With This Court's Decision In *Chiarella*, Creates A Conflict In The Circuits, And Violates the Plain Meaning Of The Statute

A. The Decision of the Court Below that Anyone Associated with a Broker-Dealer Automatically Owes a Fiduciary Duty to the Public and the SEC Is an Unprecedented and Unsupported Effort to Circumvent *Chiarella*.

The court below found that petitioner violated Section 10(b), Rule 10b-5 and Section 17(a) because, as an employee of a registered broker-dealer, he "breached his duty to the Commission and to the public not to misuse insider information." (App. C-1) This novel holding of the Court of Appeals is completely contrary to this Court's decision in *Chiarella* v. *United States*, 445 U.S. 222 (1980), and imposes on broker-dealers and other securities professionals an unwarranted public duty that will work to constrain them in performing their jobs.

In *Chiarella*, this Court held that liability under Section 10(b) and Rule 10b-5 for failing to disclose material information presupposes a legally recognized fiduciary duty to make such disclosure. This Court stated that:

> "One who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so. And the duty to disclose arises when one party has information 'that the other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between them.'" 445 U.S. at 228, quoting *Restatement (Second) of Torts* § 551(2)(a) (1976).

This Court held that such a duty arises only out of the relationship between the party in possession of the material information and the other party to the stock transaction. 445 U.S. at 232. This Court rejected the principle that "[t]he use by anyone of material information not generally available is fraudulent." *Id.*

The court below, however, found that persons associated with registered broker-dealers owe a fiduciary duty to the world. No such general duty to the public has ever before been imposed on those associated with registered broker-dealers. Although the court below purported to be affirming a conclusion of the Commission, the Commission never found that petitioner owed or breached any

duty to the public or to the Commission. Such a position was never urged upon the Commission by the Division of Enforcement and the Commission itself did not take such a position in its decision or before the Court of Appeals.

Judge Wright concluded that a general duty to the Commission and the public at large can be implied because broker-dealers are obligated to meet a high ethical standard which "restrains broker-dealers not only in their dealings with their customers, but also in their dealings with the SEC and the public at large." (App. A-29) Judge Wright found this ethical duty, in turn, in the statement by this Court, in *United States* v. *Naftalin*, 441 U.S. 768 (1979), that an objective of the securities laws is to achieve a high standard of ethics "in every facet of the securities industry," *id.* at 775. (App. A-28) Judge Wright cited as further support for his conclusion the fact that the Securities Exchange Act of 1934 imposes on broker-dealers "myriad duties not imposed on corporate officers or other members of the general public." (App. A-27)[3] And Judge Wright also cited the legislative history of the securities laws for the proposition that they were designed to prevent the sale to the public of unsound or worthless securities. (App. A-30)

From these general statements of legislative intent about ethical behavior in the securities industry, and nothing more, Judge Wright has conjured up a fiduciary

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[3] But Judge Wright nowhere found in that scheme of regulation any express duty of disclosure owed by broker-dealers to the public or the SEC. And, indeed, there is no such duty. As Judge Wright conceded, "the main focus of the SEC's regulation of broker-dealers has been to ensure that broker-dealers treat their customers honestly and fairly." (App. A-28)

duty owed by broker-dealers and their employees to all members of the public, including purchasers on the open market with whom neither the employees nor the seller have any relationship. This decision has enormous potential ramifications for broker-dealers, as well as for the rest of those professionals (such as lawyers and accountants) "in every facet of the securities industry" who are held to "high ethical standards." Judge Wright's rationale implies that all such professionals, because they should behave ethically, can automatically be held liable for securities fraud whenever their failure to disclose material non-public information to the public results in "unsound" or "fraudulent" securities being sold. (App. A-30 to A-31) Presumably such professionals could be subjected to private actions for damages under Rule 10b-5, as well as to SEC disciplinary proceedings.

In the guise of finding a duty under *Chiarella*, Judge Wright has effectively eviscerated that decision. This Court should make it clear that "ethical" obligations, if they exist, are not *ipso facto* converted into fiduciary duties, and that the antifraud provisions of the securities laws will not be used as a means of enforcing such "ethics." As this Court said in *Chiarella*, "Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud." 445 U.S. at 234-35. The decision of the court below imposes upon securities professionals unbounded duties to the public and to the SEC that unfairly and unwisely subjects them to liability under the securities laws and interferes with the performance of important activities beneficial to the public and to the open market.

B. The Decision of the Court Below that the Recipient of Information from Corporate Insiders May Inherit the Insiders' Fiduciary Duties to Shareholders or Purchasers, Even if the Insiders Breached No Duties in Disclosing Such Information, Is Contrary to *Chiarella* and Creates a Conflict Within the Circuits

Judge Wright's opinion states that the *Chiarella* requirements were met in this case because, in addition to a duty to the public and to the SEC, Dirks "became subject to his informants' disclose-or-refrain obligation." (App. A-25) Even if the two-judge Court of Appeals' judgment intended—which is far from clear[4]—to affirm the Commission's finding that Dirks was a "tippee" of corporate insiders, and thus inherited a fiduciary duty to Equity Funding shareholders, the decision is incorrect, inconsistent with *Chiarella* and sound public policy, and in direct conflict with a decision of the Second Circuit Court of Appeals.

In *Chiarella*, this Court held that in a nondisclosure case "there can be no fraud [under Rule 10b-5] absent a duty to speak" arising from "a fiduciary or similar relation of trust and confidence." 445 U.S. at 228, 235. This Court also stated that an outsider's liability for disseminating "inside information" has been viewed "as arising from his role as a participant after the fact in the insider's breach of a fiduciary duty." 445 U.S. at 230 n.12.

In this case, Dirks was a stranger to, and did not have a fiduciary relationship with, any purchasers of Equity

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[4] The March 29, 1982 three-paragraph judgment, in which Judge Robb joined Judge Wright, specifically upheld the SEC decision on the basis that petitioner "breached his duty to the Commission and to the public," but does not refer to breach of a duty inherited from corporate insiders. (App. C-1) That discussion appears only in Judge Wright's opinion, in which Judge Robb did not join.

Funding securities. Dirks was not an Equity Funding officer, director or employee. He did not own, purchase or sell Equity Funding stock and he was not involved as broker or agent in any sale. Furthermore, Dirks obtained information about Equity Funding *not* through an insider's breach of a fiduciary duty and *not* through any unethical or unlawful activities, but through the efforts of former employees to expose a fraud and in the normal course of a securities analyst's activities.[5] The SEC conceded that Dirks' sources had not breached any fiduciary duty in talking to Dirks. (SEC Court of Appeals Brief at 30.) Likewise, Judge Wright assumed that Dirks' sources breached no fiduciary duty in making their revelations. (App. A-23) Indeed, no one has ever suggested that Dirks acted unlawfully or unethically in obtaining information about Equity Funding.

In attempting to satisfy the *Chiarella* requirements, the Commission—and Judge Wright—relied, instead, upon the theory that even if Dirks himself owed no direct fiduciary duty and even if his informants had not breached any fiduciary duty nevertheless he was a "tippee" of Equity Funding corporate insiders and automatically acquired a duty to "disclose or refrain" by receiving confidential corporate information from the "insiders." (App. B-13; App. A-24 to A-25) The Commission held that the mere possession of "confidential" corporate information by one who knows that it came from inside the corporation results in an obligation to disclose that information or refrain from trading on it. (App. B-13)

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[5] In fact, under the law of California, where Equity Funding was headquartered, these employees had a duty to expose fraud or face possible criminal liability. Cal. Corp. Code § 3019 (1955), now renumbered with technical emendations, as Cal. Corp. Code § 2254 (1977).

It is true that one who receives certain types of nonpublic information may acquire a duty to disclose or refrain from trading. But it is not the receipt of *all* nonpublic corporate information that gives rise to this duty. This Court in *Chiarella* rejected the principle that "[t]he use by anyone of material information not generally available is fraudulent," requiring instead proof of "a relationship . . . that could give rise to a duty" to disclose. 445 U.S. at 232. Such a duty arises only if the person from whom the "tippee" received the information breached his own fiduciary duty in conveying it. 445 U.S. at 230 n.12.

Despite this Court's decision in *Chiarella*, Judge Wright stated that a breach of fiduciary duty by the Equity Funding insiders was not necessary in order for Dirks to acquire their fiduciary duty not to trade on the information. (App. A-24) This theory, which is essentially that adopted by the Commission, has been called by one commentator "a novel application of fiduciary attribution principles." Langevoort, *Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement*, 70 Cal. L. Rev. 1, 30 (1982).

Judge Wright's theory is also sharply at odds with what appears to be the only other post-*Chiarella* decision on this question to date. In *Walton* v. *Morgan Stanley & Co., Inc.*, 623 F.2d 796 (2d Cir. 1980), the Second Circuit Court of Appeals held that an investment banking firm did not acquire or breach any *Chiarella*-type fiduciary duty to a corporation when it traded in the corporation's stock on the basis of confidential earnings reports it acquired from the corporation while investigating it for a client. *Id.* at 798-99. Although the company's executives had a duty not to trade on the basis of such information, they did not breach any fiduciary duty by disclosing the information to the investment banking firm. The invest-

ment banking firm knew, however, that the information was confidential corporate data that came from inside the company, and had specifically been asked to keep it so. Nonetheless, the court did not find that the investment bankers acquired any duty to disclose or refrain from trading on this information when they received it legitimately. *Id.* at 799.

To the extent that the judgment of the Court of Appeals affirms the view of the Commission that the simple receipt of nonpublic information conferred on Dirks a duty to disclose, it is contrary to *Chiarella* and in conflict with *Walton*. This Court should eliminate that conflict and make it clear that a noninsider recipient of material nonpublic information does not violate Rule 10b-5, unless he is a participant after the fact in a breach of a duty of confidentiality owed by an insider.

C. The Finding of the Court Below that Unverified Rumors Are "Material Facts" Is Incorrect and Will Interfere with the Work of Analysts

Until this case, the courts have uniformly held, as the explicit language of the statutes requires, that Section 10(b), Rule 10b-5, and Section 17(a) apply only to misstatements or omissions of "material fact," *TSC Industries, Inc.* v *Northway, Inc.*, 426 U.S. 438 (1976), and not to rumors, allegations, and other unverified information. For example, in *Financial Industrial Fund, Inc.* v. *McDonnell Douglas Corp.*, 474 F.2d 514 (10th Cir.), *cert. denied*, 414 U.S. 874 (1973), the court held that before a duty to disclose information arises, "the contents must be verified sufficiently to permit . . . [those involved] to have full confidence in their accuracy." 474 F.2d at 519.[6]

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[6] *Accord, Hassig* v. *Pearson*, 565 F.2d 644 (10th Cir. 1977); *Marx & Co.* v. *The Diner's Club, Inc.*, 550 F.2d 505 (2d Cir.), *cert. denied*, 434

Judge Wright admitted that the allegations Dirks heard did not come "from a source whose word would not be doubted." (App. A-34) Yet the Court of Appeals affirmed the Commission's finding that the information disseminated by Dirks consisted of "material facts."

What Dirks disclosed were not "facts" in any known sense of the word. The allegations that Dirks heard were unverified and widely doubted in the investment community. That the allegations were never considered as "fact" is confirmed by the reactions of everyone who heard them, from Dirks or otherwise. Although some sold their Equity Funding stock, others either did nothing or actually purchased additional Equity Funding stock.[7] In addition, the various regulatory agencies charged with investigating and reporting corporate wrongdoing, including the SEC and various state insurance departments, heard the same allegations as Dirks but did not

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U.S. 861 (1977); *Mitchell* v. *Texas Gulf Sulphur Co.*, 446 F.2d 90, 94 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971); *Alaska Interstate Co.* v. *McMillan*, 402 F. Supp. 532 (D. Del. 1975).

[7] The difference between this case and a true "fact" case like *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961), or *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969), is obvious. When one of Curtiss-Wright's directors in *Cady, Roberts* tipped people about the company's falling dividend, no one bought the stock. They knew what he said was reliable and what it meant. When Texas Gulf insiders tipped people about mineral finds, no one sold the stock. Again, they knew the information was reliable and what it meant. In contrast, the reaction of the investment community, as well as regulatory agencies, in the present case makes it clear that the Secrist allegations, which were denied by Equity Funding management, were simply not "facts."

take any action on them. As Stanley Sporkin, then Deputy Director of the SEC Division of Enforcement, testified before Congress: "We were really in a quandry on the week of March 26 about what we should do. We had no real verification of the facts." Hearings Before Subcomms. of the Senate Comm. on Appropriations, 93d Cong., 1st Sess. 90 (1973).

Moreover, while it was ultimately shown, once hard evidence was uncovered, that some of the allegations heard by Dirks were true, it was also ultimately shown that other allegations, each of which initially was as plausible and as supported as the true allegations, were in fact false.[8] Indeed, in two reported cases dealing with some of the same Equity Funding allegations heard by Dirks, two courts have held that many of the same allegations were rumors, not facts, and that there was no obligation to disclose them. *See Pachter* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.* 444 F. Supp. 417, 422 (E.D.N.Y.), *aff'd mem.*, 594 F.2d 852 (2d Cir. 1978); *Wiener* v. *Oppenheimer & Co.*, [1979] Fed. Sec. L. Rep. (CCH) ¶ 96,764, at 95,001 (S.D.N.Y. 1979).

Judge Wright's opinion thus flies in the face of the explicit statutory language and prior case law. Moreover, the decision of the court below strikes a direct blow at the research function of the securities analyst. Judge Wright

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[8] Of the eight allegations made by Ronald Secrist on March 7, only three—relating to the creation by Equity Funding of fictitious insurance policies and certificates of deposit—turned out to be true. The remaining allegations, which were false, included allegations that Equity Funding only had $10,000,000 in assets; that it had fictitious real estate on its books and was selling it through limited partnerships; and that Haskins & Sells had refused to continue as auditor for EFLIC.

recognized the important role that securities analysts play in promoting efficient capital markets. (App. A-30) He did not question that Dirks' investigation was nothing more than a vigorous example of the type of research that goes on all the time. Indeed, in the present case Dirks was doing what securities analysts do every day—conducting research, talking to company officials and talking to outside experts in the industry.

Judge Wright seems to believe, however, that the right of the analyst to promote his research ends when "business ethics" suggest that the analyst make public disclosure of his findings even if what he finds is not "fact." (App. A-30) Such an obligation of public disclosure of an analyst's research efforts will impose highly uncertain new duties upon professional securities analysts. Any time an analyst uncovers or develops negative allegations or rumors on a company, the dissemination of those allegations may cause some of those who hear them to credit the allegations and to sell. If it turns out that those allegations are well founded, or even if they are not but their effect is that the stock is worth less than the price at which it was sold, it can be expected that the purchasers will turn around and sue the analyst under Rule 10b-5 for aiding and abetting the sale of an "unsound" or "fraudulent" security. That will simply assure that analysts do not undertake investigations like Dirks did here.

But for Dirks' efforts the fraud at Equity Funding might have remained uncovered for years. Indeed, Stanley Goldblum, Equity Funding's president who served a jail term for his part in the fraud, was of that view and blamed Dirks for exposing the fraud. As Dean Lorie of the University of Chicago stated: "We should see to it that the Raymond Dirkses of the future get gold medals rather than censure and other punishment." Lorie, *In-*

sider Trading: Rule 10b-5, Disclosure, and Corporate Privacy: A Comment, 9 J. Legal Stud. 819, 822 (1980). By wrongly holding that unverified allegations are "material fact" the court below has managed to achieve just the opposite result.

CONCLUSION

For the foregoing reasons, the Petition for a Writ of Certiorari should be granted.

Respectfully submitted

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